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Another tale of the Unexpected

"Elections belong to the people. It's their decision. If they decide to turn their back on the fire and burn their behinds, then they will just have to sit on their blisters."
Abraham Lincoln

It is tempting to summarise last night's UK election surprises by reference to Shakespearean plays:

Comedy of Errors	**the Conservative campaign**
Love's Labour's Lost	**only just and depends upon your viewpoint**
As You Like It	**depends upon your viewpoint**
Much Ado about Nothing	**politics is less important than the actors think**
All's Well That Ends Well	**hmmm**
Taming of the Shrew	**take your pick**

Our thoughts following yesterday's surprise UK election result are summarised below. It has implications for the domestic economy (depending on how any resulting uncertainties are handled) and potentially borrowing costs but the UK stock market implications are muted by the majority of the market's earnings being generated overseas and hence being relatively unaffected by UK domestic developments and boosted in sterling terms by weakness in the pound. The market aftermath of the Brexit vote last June was a reminder to approach investment markets analytically rather than emotionally.

Contrasting problems with Leaders. Aside from the obvious conclusions from the results themselves, there is an intriguing contrast in the outcome for the two main parties. The Conservatives will probably in time get rid of a leader with whom they were broadly happy before the election because the campaign was a personalised appeal for support that failed. By contrast, Labour moderates will be unable to get rid of a leader they don't believe in because he significantly exceeded expectations. The Conservatives found that appearing to play for a draw is not a way to win, while Labour, faced with a daunting run rate, played positively and pleased the crowds.

It is not easy to discern how much was driven by the style of the campaigns and how much by the substance of the manifestos but it seems likely that the balance in political debate over fiscal policy has shifted in favour of bread and circuses and away from troublesome arithmetic.

Potential positives.

- **No hard Brexit?** A softer line may be taken in the Brexit negotiations, since playing hard ball in Europe with only a tiny and vulnerable Commons margin will lack credibility. Furthermore, dependence on Ulster MPs, who are likely to favour an open border with Eire, is likely to give more weight to soft Brexit arguments. The UK would have had more leverage if the EU negotiators were not able to game our domestic politics because of the close balance in the House of Commons. This was requested by May in May and declined by popular will in June.

- **United Kingdom not Untied Kingdom.** Given the results in Scotland the risk of a second independence referendum has receded. The SNP's losses suggest that there is no bandwagon for independence, especially with a weaker Scottish economy than in 2014.
- **Looser fiscal policy.** It will be harder to get tax rises or spending cuts through the House of Commons and to the extent that the government risks having to fight another election soon there will be a bias towards largesse. Maintaining economic confidence and growth will be a continuing political priority, as the Commons numbers mean timing a boost later in the parliament cannot be planned. This could be compounded if a minority Labour government took office should the Conservatives fail to secure and sustain enough support from Northern Ireland Unionists.
- **Sterling weakness.** This is likely to be good for growth and equities, bad for bonds (via inflation). Although the pound bounced when the election was announced in April, it was hard to see this being sustained, unless the EU was about to give the UK a free pass on Brexit, with Jean-Claude Juncker being awarded a knighthood. With the UK running a sizeable external deficit and on the threshold of renegotiating its trading relations with its largest trading partners, a weak pound seemed on the cards whatever the election result (at least beyond the first few days, had a Conservative landslide created a sugar high). The additional uncertainty caused by a minority government (or an experimental arrangement with the Democratic Unionists) seems relatively minor by comparison with the current account and Brexit issues.
- **'You're joking – not another one!'** Harking back to the 1970s, minority governments can survive a surprisingly long time (likewise small majorities in the 1990s). One shouldn't assume an early election is inevitable, particularly with the recent cautionary tale still being written.

Negatives.

- **Brexit negotiations hostage to small groups.** Although financial markets (and probably many of last year's Brexit 52%) would be happy with a more collegiate and neighbourly approach to the Brexit talks, the tight parliamentary arithmetic means that small numbers on the pro-European and the "out at all costs" wings of the Tory party may be able to block proposals they dislike, making a deal harder to achieve. Given that the majority of the House of Commons probably remains pro-EU this seems likely to skew any deal in the direction of compromise on migration, cash contributions and other contentious issues. With a large majority, Theresa May could have shrugged off objections and pursued her own agenda but the government could now be destabilised by hard-line EU sceptics' revolts against any compromises and there is the 'enticing' prospect of Nigel Farage's stated intention to re-enter politics if necessary to defend Brexit.
- **Waiting in the wings?** Labour has not won the election but until it is clear how far the result was due to Conservative mistakes we do not know if Labour's programme would win widespread popular support in a better-fought contest. There is now clearly a closer risk of a change of government with (for markets) business-unfriendly, redistributive and relatively untried policies.
- **Domestic confidence.** The shock appears less significant than the Brexit vote was. Nonetheless lack of clarity over the medium-term economic outlook and greater political uncertainty pose risks to spending and investment which could weaken

growth. Offsetting this are renewed weakness in sterling and a more business-friendly tone to the Brexit talks.

- **Gilt yields.** Although the Bank of England is likely to err on the side of loose policy, it seems likely that fiscal policy will be looser than under a strong government and weaker sterling is likely to keep upward pressure on inflation relative to rates in other countries. We have become used to bond yields remaining low despite huge increases in government borrowing and fluctuations in inflation. As the World's central banks show signs of taking their foot off the monetary accelerator and gently applying the brakes this might change.

In our view, global investors should not overreact to yesterday's election outcome, which appears more of a political event than an economic one. There are both positive and negative implications for the UK's economy and its relations with Europe.

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